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Company Examinations

**STATE OF TENNESSEE**

**MARKET CONDUCT EXAMINATION REPORT**

**OF THE**

**PROPERTY AND CASUALTY BUSINESS**

**OF**

**DIRECT INSURANCE COMPANY**  
**(NAIC #37220)**  
**1281 Murfreesboro Road**  
**Nashville, TN 37217-2432**

**Examination Period: January 1, 2002 – December 31, 2003**

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July 12, 2004

The Honorable Alfred W. Gross  
Chairman, NAIC Financial Condition (E) Committee  
Commissioner, Virginia Bureau of Insurance  
P. O. Box 1157  
Richmond, Virginia 23218

The Honorable Paula A. Flowers  
Insurance Commissioner  
Tennessee Department of Commerce and Insurance  
500 James Robertson Parkway  
5<sup>th</sup> Floor  
Nashville, Tennessee 37243

Madam and Sir:

Pursuant to your instructions and in accordance with Tennessee insurance laws and regulations, and resolutions adopted by the National Association of Insurance Commissioners (NAIC), an examination has been made of the market conduct practices of

**Direct Insurance Company**

(NAIC # 37220)

(hereinafter and generally referred to as "the Company") at its principal offices at 1281 Murfreesboro Road, Nashville, Tennessee 37217. The report thereon is hereby respectfully submitted.

## **FORWARD**

This report is written primarily by exception, except for certain items of regulatory significance, and those matters examined and found to be substantially in compliance with Tennessee laws will not be commented on further. Standards as prescribed by the 2003 NAIC Market Conduct Examiners Handbook are only described in detail where the examiners concluded that the Company was not meeting a specific standard. Such tests and review were conducted as were deemed necessary or appropriate to determine the Company's compliance with Tenn. Code Ann. § 56 and conformance to NAIC market conduct standards. The details of these tests are included where relevant and supportive of the examiners' conclusions.

## **SCOPE OF EXAMINATION**

This is the initial market conduct examination of the Company by the Tennessee Department of Commerce and Insurance (hereinafter referred to as the Tennessee Department). The examination commenced on January 19, 2004 and covers the period from January 1, 2002 through December 31, 2003, including relevant subsequent events. The examination was made pursuant to Tenn. Code Ann. § 56-1-408, and conducted by representatives of the Tennessee Department. The examination and testing methodologies follow the standards established by the National Association of Insurance Commissioners and procedures developed by the Tennessee Department of Commerce and Insurance and accordingly included tests of the following aspects of the Company's operations:

- Company Operations/Management
- Policyholder Service
- Complaint Handling
- Underwriting and Rating
- Marketing and Sales
- Claims
- Producer Licensing

Testing performed during the review provided a credible basis for the findings and recommendations contained in this report.

## **PROFILE FACTS**

The Company was incorporated on November 8, 1990. The Charter of Incorporation was filed with the Tennessee Secretary of State on April 10, 1991. On April 11, 1991, the Company was issued a Certificate of Authority to transact the business of property and casualty insurance in the State of Tennessee. The Company commenced business on April 12, 1991.

Effective December 2, 1994, the Company became a member of the Direct General Corporation, the holding company system. The Company has no employees but is party to an intercompany cost sharing agreement whereby affiliates, through the parent company, provide underwriting and policy issuance, claims settlement, premium financing, and administrative services.

The Company writes private passenger non-standard automobile insurance for consumers who are unable to obtain insurance from the standard market due to a variety of factors, including lack of flexible payment plans, the failure to maintain continuous coverage, age, prior accidents, driving violations, occupation and type of vehicle. The Company's products are primarily sold directly through affiliated insurance agencies located in neighborhood sales offices. The majority of the policies sold are financed by an affiliated premium finance company. The affiliated agencies are paid commissions in accordance with agency agreements.

On December 31, 2003, the Company was licensed in Arkansas, South Carolina and Tennessee; however, the Company is currently only writing policies in Tennessee and Arkansas. The Company's direct written premium, by state, is presented as follows:

	<b>Arkansas</b>	<b>Tennessee</b>	<b>South Carolina</b>
December 31, 2002	\$ 10,250,037	\$ 56,268,073	\$ -0-
December 31, 2003	\$ 11,091,380	\$ 59,727,037	\$ -0-

### **EXECUTIVE SUMMARY**

The Tennessee Department of Commerce and Insurance, Insurance Division conducted a comprehensive full scope market conduct examination of Direct Insurance Company. The Company is a member of the Direct General Corporation group and is licensed to transact private passenger automobile business in Tennessee, Arkansas, and South Carolina.

The focus of the examination was a review of the Company's operations/management, complaint handling, marketing and sales practices, producer licensing, policyholder services, underwriting and rating and claims procedures and general compliance with Tennessee laws.

The examination disclosed that the Company contracted with an affiliate and an outside law firm to provide premium finance services and subrogation collection services. The affiliated agreement is unsigned and there is no written agreement with the law firm. These appear to be unsound business practices.

In addition, the Company has engaged the services of an affiliate, Direct General Insurance Agency, Inc. (DGIA), for sales, marketing and underwriting services. Insurance applicants are charged, by DGIA, for the cost of securing the applicant's motor

vehicle report. This charge is contrary to a directive issued by the Tennessee Insurance Department, under which such charges are prohibited.

For Complaint Handling, the Company is not in compliance with Standard #1 which requires that all complaints be recorded in the required format in the Company's complaint register. The company failed to record 13 complaints received from the Tennessee Insurance Department.

The Company is in violation of Tenn. Code Ann. § 56-6-115 relating to the appointment of producers. The review disclosed 14 agents without appointments. A violation of § 56-6-117 was disclosed as the company's records disclose the termination of 18 producers who are still reflected as active on the Department's records. In addition, the review disclosed that there were 12 producers, noted by the Company as appointed and terminated during our examination period, but not reflected as appointed and therefore not terminated on the Department's records. The Company was advised to immediately contact the Agent Licensing Section of the Tennessee Department of Commerce and Insurance in order to resolve these exceptions.

During our review of underwriting files, an error rate of 48% was disclosed. This error consisted of 22 files for which the application document was not available, 20 files that contained incorrect symbols, 5 files had invalid VIN numbers and 1 file did not contain updated endorsements. These errors are in non-compliance with Standard # 27, Statistical coding which requires that all policies are correctly coded and Standard # 18, Underwriting Practices which requires that the Company verify that VIN number submitted with application is valid and that the correct symbol is utilized.

The review of claim files noted that once the subrogation process started, no related documents were included in the claim file. Information was contained in the "notepad" system disclosing amounts recovered and deductibles, if any, returned. There appeared to be adequate documentation to justify claim decisions, but there was inadequate



documentation in the claim file for a proper review of the subrogation and salvage activities. Further, our review disclosed differences in comparing closed date per the claim run and the closed date in the file documentation.

The Company's Proof of Loss/Trust Agreement does not include any fraud warning as required by Tenn. Code Ann. § 56-53-111(b) (1) (A).

### **PREVIOUS EXAMINATION FINDINGS**

This is the first separate full scope market conduct examination performed on the Company by the Tennessee Department; thus there are no previous examination findings.

### **PERTINENT FACTUAL FINDINGS**

#### **Company Operations/Management**

##### History:

As discussed above, the Company was incorporated on November 8, 1990. The Charter of Incorporation was filed with the Tennessee Secretary of State on April 10, 1991. On April 11, 1991, the Company was issued a Certificate of Authority to transact the business of property and casualty insurance in the State of Tennessee. The Company commenced business on April 12, 1991 offering private passenger non-standard automobile insurance.

The Company is authorized to issue forty thousand (40,000) shares of common stock, each share to have a par value of one hundred and fifty dollars (\$150). To December 2, 1994, 16,794.5 shares were issued and outstanding. Effective December 2, 1994 all 16,794.5 shares were acquired by Direct Corporation, now known as Direct General Corporation, a Tennessee corporation. A summary of the Company's current capitalization at December 31, 2003 is presented as follows:

Date	Number of Authorized Shares	Par Value	Shares Issued and Outstanding	Common Stock	Gross Paid In & Contributed Surplus
12/31/2003	40,000	150.00	16,794.50	\$ 2,519,175	\$ 11,823,125

### Management

The Company's Bylaws state, "The business and affairs of the Corporation shall be managed by a board of directors." The following persons had been duly elected by the shareholders and were serving as members of the board at December 31, 2003:

<u>Name</u>	<u>Business Address</u>	<u>Principal Occupation/Affiliation</u>
Jacqueline Crawford Adair	1281 Murfreesboro Road, Nashville, TN 37217	President of the Company
Tammy Renee Adair	1281 Murfreesboro Road, Nashville, TN 37217	Executive Vice-President of the Company
Barry Douglas Elkins	1281 Murfreesboro Road, Nashville, TN 37217	Senior Vice-President of the Company

The Bylaws provide that the board of directors shall have a Chairman of the Board, a Chief Executive Officer, a President and a Secretary, and such other officers as the board of directors shall from time to time deem necessary. At December 31, 2003, the following persons had been duly elected as officers and were serving in the positions indicated:

Jacqueline C. Adair	President
Tammy R. Adair	Executive Vice President
Barry D. Elkins	Senior Vice President
John T. Hagely	Treasurer
Scott A. Johnson	Vice President - Claims
Matthew P. McClure	Secretary
Constance A. Collins	Assistant Secretary
Norma J. Shirk	Assistant Secretary

### Intercompany Agreements

#### 1. 2000 Tax Allocation Agreement

Effective November 9, 2000, the Company and its affiliates entered into an agreement with their ultimate parent, Direct General Corporation (DGC) whereby the Company would be party to the filing of a consolidated federal income tax return filed by DGC. Each member of the agreement would compute its tax liability as if it were filing a separate tax return and pay the tax liability, including quarterly estimated taxes, to the parent.

#### 2. Account Settlement Agreement

This agreement provides for the Company and its affiliate, Direct General Financial Services, Inc. a premium finance company, to settle the premiums financed, on a net basis, up to maximum of \$6 million without the specific approval of the Tennessee Insurance Commissioner. This arrangement was approved by the Tennessee Department of Commerce and Insurance on July 31, 1998. It is noted that the agreement is not signed. **It is recommended that the Company immediately take the necessary action to execute this agreement and forward a copy of the executed document to the Tennessee Department of Commerce and Insurance, Insurance Division, in accordance with the requirements of Tenn. Code Ann. § 56-11-206.**

### 3. Intercompany Cost Allocation Agreement

This agreement effective April 29, 1997, and executed by the Company that date, is by and between the Company and DGC whereby DGC, through Direct Administration, Inc. will provide administrative and management services, such as financial, legal, accounting, tax and other business and planning services to the company. Direct Adjusting Company, Inc. will provide management of insurance claims, including the appraisal of damage and all claims adjusting services. Compensation for these services is to be "fair and reasonable". For the year 2002, the company paid \$3,504,000 for administrative and management services and \$4,729,000 for claims services. For the year 2003, the costs were \$3,278,000 for administrative services and \$5,311,000 for claim settlement services.

### 4. Producer Agreement

Effective January 2000, the Company entered into an agreement with Direct General Insurance Agency, Inc. (DGIA) whereby the Company appointed and authorized DGIA to provide insurance quotes, bind coverage, solicit and accept applications for personal automobile business. In addition, the DGIA was authorized to issue, countersign and deliver policies, endorsements, certificates and binders, collect premiums and to provide the usual and customary services of an insurance agent on all contracts of insurance of the Company. Compensation for these services is to be 15% of the Company's net written premiums. For the year 2003, the cost for agent services was \$7,979,000.

### Operations

The Company primarily writes private passenger auto liability and physical damage coverage on nonstandard risks. The Company primarily markets its products on a direct to customer basis. The Company's sales, marketing, underwriting, claims and premium finance functions are conducted by salaried employees of affiliated entities.

Sales and underwriting services are provided by Direct General Insurance Agency, Inc., a Tennessee corporation. A small portion of the Company's business is written through several independent insurance agencies. The independent agencies are compensated by commissions based on a percentage of net written premiums. Claims settlement services are provided by Direct Adjusting Company, which is located in Memphis, Tennessee. Policyholder services are provided by Direct Administration, Inc. located in Baton Rouge, Louisiana.

During the sales and underwriting process, the applicant completes an agency form # U001 02/00, "Underwriting Consent Form", whereby the applicant is acknowledging responsibility for reimbursing the agent for the cost of securing the applicant's motor vehicle records (MVR).

On January 8, 1998, the Tennessee Department of Commerce and Insurance issued a Bulletin to clarify the Department's position on the issue of fees charged by insurance agents. The bulletin reiterated that all charges and costs incurred by an insured in connection with the purchase of a policy of insurance must be included in the rates which insurance companies are required to file with the Department pursuant to Tenn. Code Ann. § 56-5-301 et seq. Any charge to an insured by an insurance agent in connection with the sale, solicitation, or negotiation of an insurance policy must be reflected in the schedule of rate files with the Department. Services associated with the sale, underwriting, issuance, or servicing of a policy of insurance are performed by an agent in connection with the sale, solicitation, or negotiation of a policy of insurance and are therefore included in the Company's rate filings. Based on the Department's bulletin, the agency is prohibited from charging the applicant for the MVR. **It is therefore recommended that the Company immediately direct the agency to cease charging insurance applicants for the MVR.**

## Premium Finance

Over 95% of the Company's written premiums are financed by Direct General Financial Services, Inc. (DGFS). Under the terms of the cost allocation agreement, to which both the Company and DGFS are parties, DGFS offers premium financing to Company's insureds.

DGFS offers the following five payment option plans:

<u>Payment Option</u>	<u>Policy Terms</u>	<u>Down Payment</u>	<u>Annual Percentage Rate</u>	<u>Installment Due Dates</u>	<u>Number of Installments</u>
1	6 months	30%	42.58%	30 days	4
2	6 Months	22%	43.30%	20/27 days	5
3	6 Months	21%	44.57%	14/28 days	5
4	12 Months	15%	32.18%	30 days	10
5	12 Months	9%	32.18%	14/28 days	12
6	12 Months	11%	32.10%	20/27 days	12

Under the 30 day plan, the insured pays the down payment and then makes even payments on a monthly basis starting 30 days after the policy inception.

The 14/28-day plan, the first payment, after the down payment, begins 14 days after the policy inception and then 28 days for the selected number of payments.

The 20/27day plan is similar to the 14/28-day plan except that the first payment is due in 20 days and the remaining payments every 27 days thereafter.

A service charge of 4%, of the financed amount, is included. This amount is fully earned upon the execution of the agreement and is non refundable. In the event of a default of ten days or more, a minimum of \$2.00 up to 5% of the delinquent payment is charged. If the default results in a cancellation for non-payment, a cancellation fee

of \$5.00 is levied. These penalty fees charged by DGFS are in accordance with Tenn. Code Ann. § 56-37-109.

During our examination, a number of financing agreements were reviewed for compliance with Tenn. Code Ann. § 56-37-107. No exceptions were noted.

#### Subrogation

The Examiners were advised that the Company utilizes the services of the law firm of White, Schuerman, Rhodes & Burson of Brentwood, Tennessee to take the appropriate action to recover the damage suffered by the insured from any person who may be legally liable.

As compensation for these services, the law firm deducts 33% of the recovered amount. The Company stated that the current practice is for the fee to be assessed only against the portion of the recovery over and above the amount of the insured's deductible.

As of the date of this examination, there is no written agreement to outline this arrangement. Sound business practice would dictate the need for an agreement outlining the arrangement. **It is recommended that the Company take the necessary steps and execute an agreement with the law firm of White, Schuerman, Rhodes & Burson and forward a copy of the executed agreement to the Tennessee Insurance Commissioner.**

#### Certificates of Authority

The Certificates of Authority issued to the Company were reviewed for the period under examination. These certificates were reviewed to determine compliance with the provisions of Tenn. Code Ann. § 56-2-201. As of the date of this report, the Company was licensed in Arkansas, South Carolina and Tennessee.

The Company's Tennessee Certificate of Authority allows it to transact the business of property and casualty business. Currently, the Company only writes business in Arkansas and Tennessee.

The Company's writings in Tennessee were deemed to be in compliance with the authority granted.

#### Internal Audits

Standard 1, Company Operations/Management, recommends that the Company have "an up-to-date, valid internal or external audit program". The Company's internal audits are those performed on claim files by a full-time claims auditor. The Company is audited annually by an independent CPA firm in accordance with Tenn. Code Ann. § 56-1-501(h), and as such, appears to be in conformance with Standard One.

#### Antifraud Initiatives

The Company, as required by Tenn. Code Ann. § 56-53-111, has a written antifraud plan and investigative personnel in order to detect, prosecute and prevent fraudulent insurance acts.

#### Disaster Recovery Plan

The Company has a valid disaster recovery plan. Effective the year 2000 and as amended in the year 2004, the plan provides for the safeguarding of data. Backup copies of data are cycled offsite on a daily basis and maintained at locations in Nashville, Memphis and Knoxville, Tennessee as well as in Baton Rouge, Louisiana and Tampa, Florida.



### Computer Systems

The Company runs the Specialty Insurance Services (SIS) software program, which has been customized for its operations, on an IBM AS400 mainframe computer system. The program includes sub-menus for the different areas of insurance company operations, including a Client Data Base, Policy Administration, Billing, Claims Management, Statistical Reporting and Casualty Information. Access to the SIS system and other word processing, spreadsheet and Internet access programs is provided to individual workstations through a local area network (LAN) server. Individual access to the system is restricted by Company assigned user names and passwords.

All underwriting, rating and claim information is available electronically through the company's AS400 system. Handwritten documents, such as vehicle inspections, as well as any documents that require signatures, such as applications and endorsements, are scanned and available for viewing at workstations using the Citrix – Darts Imaging software program. Only documents related to underwriting are currently being scanned. Also, only documents related to policies written since June 2002, the date the company implemented the scanning technology, were available electronically.

### Privacy

The Company's Privacy Statement was reviewed and appears to comply with Tenn. Comp. R. & Reg. § 0780-1-72. The statement is included and presented to each policyholder with each new and renewal policy.

The Company's procedures for privacy and the management of insurance information are not extensive, but appear to be adequate to the Company's operations.

### Complaint Handling

The Company defines a complaint as any written or oral communication primarily expressing a grievance. All complaints originating from a regulatory agency is routed to a Complaint's Coordinator who is located in Nashville, Tennessee. A direct consumer written inquiry is routed to the customer service department in Baton Rouge, Louisiana, or to the legal department in Nashville, Tennessee. Verbal inquiries are not recorded.

The Company maintains a log and files for the complaints that involve a regulatory agency such as a state insurance department. A separate list is maintained for complaints from individuals, the Better Business Bureau and attorneys. The regulatory listing showed that, for Tennessee, the Company received 64 complaints in 2002 and 44 in 2003. The second list showed a total of 30 complaints, 21 of which were for Tennessee. The examiners reviewed the files to determine whether the Company was handling complaints in a timely, fair and consistent manner. Initially the Company was unable to provide twelve (12) files for review. Subsequently on May 25, 2004, June 18 and June 25, 2004 all files were received.

The Tennessee Department, Consumer Services Division, maintains, electronically since January 1, 2003, a list of complaints against insurers. The list, for the year 2003, was provided to the examiners and compared to Company records. The Company log did not contain the following 13 Tennessee Department complaints:

<b>TDCI Complaint Number</b>	<b>Date Received</b>	<b>Notes</b>	<b>Reason for Complaint</b>	<b>Disposition</b>
* 1296	3/12/2003		Unsatisfactory settlement offer	Company position upheld
1578	3/20/2003	CL # 480399	Other	Claim settled
1515	3/26/2003		Premium notice/billing	Company position upheld

* 1544	3/27/2003 CL # 54314	Unsatisfactory settlement offer	Recovery
1690	4/7/2003 CL # 589700	Cost containment	Recovery
1787	4/10/2003 CL # 563116	Delays	Other
* 1871	4/23/2003	Other	Claim settled
1893	4/23/2003 TNPd 145400123	Delays	Company position upheld
1933	4/25/2003 CL # 593626	Unsatisfactory settlement offer	Claim settled
1928	4/28/2003 CL # 562411	Unsatisfactory settlement offer	Delay resolved
2026	5/4/2003 CL # 596131	Delays	Delay resolved
2117	5/13/2003 Law firm made complaint on behalf of #1787	Unsatisfactory settlement offer	Company position upheld
4720	11/20/2003	Cancellation	Cancellation notice withdrawn

\* On June 21, 2004 the Company provided the complaint file for review, however the complaint was not recorded in the Company's log.

Complaints Standard #1 requires that all complaints be recorded in the required format on the company complaint register. It appears the Company is not in compliance with this standard. **It is recommended that the Company ascertain that all written complaints including those received from insurance departments be logged into its Complaint Register.**

The available files reviewed were found to contain adequate documentation of communication with complainants and regulatory agencies, and support for the final disposition of the complaint.

Some common types of complaints were:

• Claim handling delays	75.28%;
• Claim handling medical payment	1.12%;
• Claim denied for other reasons	7.87%;
• Amount of loss settlement not satisfactory	15.73%;
• Refund	6.48%;
• Underwriting issues	10.18%;
• Other	0.93%

### **Marketing and Sales**

The Company has no separate marketing department, nor is there any formal marketing plan. Advertising is designed and produced by a local independent advertising agency, JBS Communications, and is limited to television spots and phone book yellow page ads and listings. The TV and yellow page advertising is basically for “solicitation of inquiry” designed to prompt potential customers to contact a local sales office or call a toll free quote number. The advertising does not make specific representations about any particular coverage, cost, benefit or limitation. The Company’s parent maintains a web site that refers to all products offered throughout the holding company system by type, (life, auto, travel protection and hospital indemnity) and identifies them by the state in which they are offered. Also, included are listings of sales offices with telephone numbers and locations by state and city as well as the toll free quote number.

The examiners reviewed the following information provided by the Company in use in its advertising efforts to determine compliance with applicable statutes, rules and regulations of the Tennessee Department of Commerce and Insurance as well as the guidelines contained in the NAIC Market Conduct Examiners Handbook:

- Printed scripts of television advertising spots
- Bell South Yellow page full page advertising
- Bell South Yellow page representative advertising listing
- Web site [www.Direct-General.com](http://www.Direct-General.com)

The examiners also reviewed the following information provided by the Company in use in the training of and communication with sales agents:

- Model Office Training manual
- Direct agent reference manual
- Direct General Corporation employee handbook
- Direct Standard Practice Memorandum Collection

A review was conducted of the marketing and sales materials provided by the Company to determine compliance with the provisions of Tenn. Code Ann. § 56-8-104, "Unfair methods of competition and unfair or deceptive acts or practices." Policy benefits, limitations and exclusions appear to be fairly disclosed with no misleading or incomplete statements noted. All documentation reviewed appeared to be in compliance with statutes and regulations and no unlawful marketing practices were disclosed.

The Company's website, which can be found at [www.direct-general.com](http://www.direct-general.com) as noted above, was also perused. There were no unlawful rebates or inducements offered, nor were there any other violations noted with respect to the promotional material reviewed.

### **Producer Licensing**

The purpose of the producer licensing review is to test the Company's compliance with Tennessee producer licensing laws and rules and to attempt to detect any fraud or misuse of funds held by the producers.

Tenn. Code Ann. §56-6-101 and §56-6-153 require the Company to appoint each producer with whom the Company transacts business and to terminate that appointment when they cease doing business.

Agency services are provided by an affiliate, Direct General Insurance Agency, Inc. (Agency), pursuant to a contract with the Company's parent, Direct General Corporation.

Under the terms of the contract, Direct General Corporation engages the services of Agency to provide agency services to the Company. Agency's producers are salaried personnel and receive no commissions.

The examiners received from the Company a list of licensed producers, active, appointed or terminated during the period under review. The list included Agency producers and independent producers. The Company's list was compared to the records on the website of the Insurance Division of the Department of Commerce and Insurance. The following fourteen (14) producers appear to be without an appointment by the Company:

<u>Producer License Number</u>	<u>Company Appointment Date</u>
641023	02/04/04
709334	01/15/02
874676	01/03/03
*858739	01/14/02
780257	12/27/02
*877721	10/30/02
*869913	08/07/02
870322	09/09/02
*886034	05/28/03
*849212	02/01/02
888293	07/29/03
*897853	11/18/03
672653	09/08/03
789732	02/14/03

\* Appointment notices were resubmitted to the Tennessee Agent Licensing Section on April 19, 2004.

The above noted exceptions are not in compliance with Standard #1, which requires Company appointment records to agree with insurance department records. This exception is also a violation of Tenn. Code Ann. §56-6-115.

The following eighteen (18) producers were terminated on the Company records but active according to State records:

<u>Name</u>	<u>Company</u> <u>Termination Date</u>
*Byrge, Rachel	05/02/03
*Cobb, Adrienne C	09/05/03
*Davies, Tenesha L	10/15/01
*Disney, Deica D	08/30/02
*Gable, Tracy R	05/23/02
*Hodge, Gerrilynn M	06/07/02
*Kravitz, Steven N	04/09/03
*Lewis, Brittnee M	04/30/02
*Madden, Christy E	04/10/02
*McNutt, Stephan T	09/25/02
*Rogers, Charles D	08/10/01
*Shoun, James M	08/29/03
*Stamey, Pamela D	11/26/01
*Theriault, Sharon M	07/22/01
*Walker, Chasrun K	12/04/01
*Ward, Howard K	10/24/03
*Weaver, Gary R	12/28/01
*Wilson, Kathy F	08/09/02

\* Termination notices were resubmitted to the Tennessee Agent Licensing Section on April 19, 2004

The above noted exception is not in compliance with Standard #3, pertaining to compliance with state law, Tenn. Code Ann. §56-6-117 requiring not only notice of termination to the producer but also the State.

The following twelve (12) persons, noted on the Company's list of terminations for the period under review, do not reflect appointments according to State records, and therefore could not be terminated:

<u>Name</u>	<u>Company Termination</u> <u>Date</u>
Axley, Anthony R	08/15/03
Carmouche, Thomas J	07/20/02
Cox, Jimmy E	09/25/03
Jones, Brian W	08/06/03
Jones, Charlotte J	07/03/02
Jones, Melanie A	12/23/02
Ketterhagen, Thomas	07/18/03
McDonnell, Christina	07/31/03
Rowlett, Frances J	01/23/03
Scruggs, Donnita D	05/10/02
Swanier, Martha A	10/14/02
Wright-Cunningham, Quercia	11/04/03

Based on the above noted exceptions, the Company is not in compliance with Standard #1 and Standard #3. It also appears that the Company is in violation of Tenn. Code Ann. §56-6-115 and §56-6-117 pertaining to appointments and terminations of producers. During the examination, the Company provided copies of appointment and termination forms purportedly forwarded to the Agent Licensing Section of the Tennessee Department of Commerce and Insurance. The Company was advised to contact the Tennessee Agent Licensing Section to resolve these exceptions. **It is recommended that the Company develop and establish procedures to ascertain that producer authorities are in accordance with Tenn. Code Ann. §56-6-101 et seq.**

#### Policyholder Service

Policyholder service functions are performed by an affiliate of the Company, Direct Administration, Inc. Direct Administration, Inc. performs underwriting functions and its personnel are physically located in Baton Rouge, Louisiana. The claims personnel are employees of the Direct Adjusting Company and are located in Memphis, Tennessee. Most of the policyholder service functions are performed by telephone communication by the underwriting and claims departments in response to insureds' inquiries. Correspondence related to claims is maintained in the claim files. Other correspondence,



such as that requesting cancellation, is scanned into the Company's computerized policy system.

More than 95% of the Company's business is financed by an affiliate, Direct General Financial Services, Inc. (the finance company). The premiums are forwarded to the Company in accordance with the terms of a Settlement Agreement discussed in this Report under the caption, Intercompany Agreements. A sample of one hundred (100) policy records was reviewed for timely execution of policy issuance, insured-requested cancellations, claims history requests and premium invoice mailing. No exceptions were noted.

A sample of one hundred (100) cancellations was reviewed for compliance with Tenn. Code Ann. §56-7-1303 and §56-37-110. No exceptions were noted.

### **Underwriting and Rating**

#### **Rates and Policy Forms**

TCA 56-3-305(a) requires that insurers file with the Tennessee Department "all rates, supplementary rate information, supporting information, policy forms, and endorsements at least thirty (30) days before the proposed effective date."

Rates for the Company's Tennessee auto policy were most recently approved by the Tennessee Department on November 25, 2002 for new business effective January 1, 2003 and February 15, 2003 for renewals.

An endorsement, Form TN 021A, was submitted to and received by the Tennessee Department of Commerce and Insurance on June 18, 2002.

The Company offers both six-month and annual policies. Premiums are paid in full by the affiliated premium finance company, Direct General Financial Services, Inc., through which the applicant/insured has financed the premiums. Over 95% of the Company’s business is financed by the premium finance company.

A random selected sample of 100 was selected to verify that premiums charged were calculated in accordance with filed rates and underwriting guidelines.

A sample of 100 policies was selected to verify that rating attributes such as class, territory, symbol assignment, deductibles, limit and discounts were in accordance with Company filed underwriting guidelines. Exceptions were noted in the symbol assignment. In addition, a random sample of twenty-one files was selected and premiums charged were recalculated in accordance with filed and approved rates. No exceptions were noted.

In accordance with TCA 56-7-1201(a), the Company’s Tennessee policy applications offer uninsured motorists’ coverage. If the coverage is not desired, applicants must reject the coverage by signing an “Uninsured Motorist Coverage (UM)” statement.

Underwriting

The Company writes non-standard automobile policies that provide primary coverage limits in Tennessee as follows:

<u>Coverage</u>	<u>Basic Limits</u>
Bodily injury per person	\$25,000
Bodily injury per occurrence	\$50,000
Property damage per occurrence	\$10,000

Discounts are given for renewals, prior insurance, multi-car coverage, homeownership and senior operator accident prevention courses.

During the review of our sample of 100 underwriting files, we noted that forty-eight (48) files, a 48% error rate, were incomplete or incorrectly coded. The forty-eight (48) errors consisted of twenty-two (22) incomplete files, twenty (20) with incorrect assigned vehicle symbols, five (5) were assigned invalid VIN numbers and one (1) did not contain the updated endorsement.

The following schedule reflects the incomplete file findings:

Incomplete files

TNP 000171362	TNPD139000424
TNPD100205205	TNPD140100242
TNPD100303266	TNPD198400035
TNPD101103376	TNPD199904366
TNPD101402868	TNP 000145203
TNPD101503677	TNPD100201611
TNPD101600865	TNPD101503299
TNPD102004384	TNPD101805612
TNPD117402624	TNPD103101614
TNPD119002737	TNPD132901436
TNPD139000416	TNPD199900845

The Company's policy system was fully automated on June 10, 2002. The twenty-two incomplete files did not contain the application document and were effective prior to June 10, 2002. A request was made to have the Company provide the missing documents. The request was not fulfilled as of the examination date.

The following schedule reflects the invalid VIN number findings:

Invalid VIN Numbers

TNP 000033045  
TNP 000091833  
TNP 000168720  
TNPD101506453  
TNP 000162182

Standard #18 tests that the company verifies that the VIN number submitted with the application is valid and that the correct symbol is utilized. From the remaining seventy-eight (78) policies from the sample of one hundred (100), five (5) files, a 6% error rate, disclosed invalid VIN numbers. It appears the Company is not in compliance with this standard. **It is recommended that the Company establish a procedure to verify data input into the system.**

The following schedule reflects errors found in the differences in vehicle symbols and endorsements:

Vehicle Symbol Differences

TNP 000080717	TNPD103610582
TNPD100207851	TNPD103610878
TNPD100305105	TNPD133200638
TNPD100306549	TNPD138900369
TNPD100908262	TNPD139401582
TNPD101002792	TNPD139403506
TNPD101306036	TNPD198700559
TNPD101307735	TNPD198905288
TNPD102503360	TNPD198906656
TNPD103102189	TNPD199104600

No Updated Endorsements

TNPD199905392

### Use of Correct and Properly Filed Forms and Endorsements

Tenn. Code Ann. § 56-3-305(a) requires that insurers file Tennessee policy forms and endorsements with the Tennessee Department at least 30 days prior to their use.

The examiner reviewed the policy forms filed by the Company during the examination period to confirm that they had been duly filed and approved for use. For the period under examination, the Company filed an endorsement, form number TN 021A, which was received by the Tennessee Department on June 18, 2002. No exceptions were noted.

### Termination Practices

The majority, over 95%, of the policies sold are financed by the Company's affiliate, Direct General Financial Services, Inc. The Company receives 100% of the premium from the finance company. Installment notices and billings are sent to the insured by the premium finance company. Cancellations are processed after notice from the finance company of a default by the insured. Reinstatements are requested by the finance company, after the receipt of the past due installment, however the installment may not be over 30 days past due.

The Company utilizes a form called a "Statement of No Loss" for reinstatements. When an insured's policy lapses for nonpayment of premium, the Company offers the insured the option of reinstating the policy with no lapse of coverage if the insured will sign the Statement of No Loss attesting that no loss was suffered on the risk(s) insured between the lapse date and the date of reinstatement.

Return premiums are calculated pro-rata if cancelled at the request of the finance company and short-rated if requested by the insured.

### Declination Practices

The Company rarely declines a prospective insured as the online policy system rejects applications that contemplate risks outside of the Company's underwriting guidelines. During the period under examination, there were seven hundred and forty-seven (747) recorded declinations. A sample of fifty was selected for review. Our sample disclosed no unfair or discriminatory declinations.

### Reinsurance

Tenn. Code Ann. § 56-3-116 states, "no insurance company engaged in the business of property and casualty insurance shall retain a maximum net amount on any single risk in excess of ten percent (10%) of such company's capital." As the Company's net aggregate amount insured in any one risk is \$37,500, and at December 31, 2003, capital totaled \$20,531,788, it appears that the Company is in compliance with the above Tennessee statute.

### Statistical Coding

The Company's policy system is updated with each new rate and form filing. The Company's underwriting manual is specific as to how data can be entered into the system.

## Claims:

### General Overview

The examination process is to provide a view of claim practices in order to determine that the Company's treatment of claimants is in compliance with Tenn. Code Ann. § 56-8-104(8). The Company provided complete listings of Tennessee claims, open, closed, and closed with recoveries, for the examination period. From these listings samples of 100, 50 and 50 claims respectively were extracted by using the random number generator function in Microsoft Excel, based on a 95% confidence level and an expected error rate of 2% or less.

### Time Study to Measure Acknowledgement

The Company's claims are processed by its affiliate, Direct Adjusting Company, Inc., under an intercompany agreement, as noted previously in this report. A time study was performed on the acknowledgement for the 150 closed and open claims sample files. Following is the summary of the range of the number of days between the date the loss was reported and the date the adjuster made initial contact. The initial contact for the purposes of Claims Standard #1 involved comparing the date the incident was initially reported to the date that the assigned adjuster actually spoke to the claimant and/or insured. In only one case was the delay in initial contact unreasonable.

<u>Number of Days</u>	<u>Range</u>	<u>Average</u>	<u>Median</u>
Closed Claims	0-60	5	2
Open Claims	0-176	16	4

### Time Study to Measure Investigation

To determine coverage from reported date:

<u>Number of Days</u>	<u>Range</u>	<u>Average</u>	<u>Median</u>
Closed Claims	0-35	1	Same day
Open Claims	0-38	3	Same day

To determine liability from the date that coverage was determined:

<u>Number of Days</u>	<u>Range</u>	<u>Average</u>	<u>Median</u>
Closed Claims	0-166	11	2
Open Claims	0-324	24	10

To determine liability from date of acknowledgement:

<u>Number of Days</u>	<u>Range</u>	<u>Average</u>	<u>Median</u>
Closed Claims	0-161	7	Same day
Open Claims	0-272	21	4

To determine resolution of the claim from liability determination to settlement:

<u>Number of Days</u>	<u>Range</u>	<u>Average</u>	<u>Median</u>
Closed Claims	0-384	38	11

There was one instance in which the delay was due to inadequate efforts to maintain contact with the claimant and/or insured.

### General Handling Study

A sample of the Company's closed and open claim files was reviewed for adequate and accurate documentation. Electronic claim records, as maintained by the Claims Management System on the Company's AS400, were compared to claim files for



accurate recording of identifying data such as claim/policy number, date of loss, claimant name, limits of coverage and deductibles. Claim and expense checks were reviewed for correct payees.

#### Closed Claims

A sample of one hundred (100) claims closed during the period under examination was reviewed. Four (4) files lacked sufficient hard copy documentation to support the claim decisions, two (2) lacked basic documentation, one (1) lacked a rental car bill and one (1) contained no damage appraisal for a total loss. The "notepad" system provided sufficient electronic detail about the claims processing and it appeared that all four cases were settled to the satisfaction of the claimants.

#### Open Claims

A sample of 50 open claims, as of December 31, 2003, was reviewed. Three (3) files lacked adequate hard copy documentation one (1) had no copy of the "Reservation of Rights" letter as there was a coverage question which was eventually resolved; one (1) had no documentation at all due to loss of the file and one (1) contained no documentation as related to a bodily injury claim). Again, the "notepad" system provided sufficient electronic detail to indicate that the claims appeared to be handled in an acceptable manner.

#### Total Loss Survey

The Company's claim files were reviewed for consistency of vehicle evaluation, correct disposition of salvage and compliance with state requirements for transfer of title and registration. The Company uses the National Automobile Dealers Association (NADA) and Certified Collateral Corporation's (CCC) valuations to calculate depreciation and salvage values. Forty-four (44) claim files involving a total loss were selected for review.

All related file documentation appeared complete and reasonable and no exceptions were noted in the Company's valuation of total loss.

#### Closed Without Payment Review

Claims closed without payment includes those that are denied or rejected for specific reasons stated in the auto insurance policy, and those that are incomplete as to adequate proof of loss documentation. Forty-two (42) files were subjectively selected for review. Only one file was found to be inadequate due to the lack of a copy of a "10 day letter". The "notepad" system detailed many unsuccessful contact attempts with the claimant. No other files were deemed to be incomplete as to adequate documentation.

#### Salvage and Subrogation Survey

The purpose of this procedure is to review a representative sample of the subrogated claims with complete or partial recoveries. The Company has a decentralized approach to documenting claim files that involve salvage and subrogation. A claim that involves a total loss is referred to a salvage team in Baton Rouge, Louisiana, for disposition and where a separate salvage file is created. Claim files that are determined to have subrogation potential are copied and forwarded to a law firm in Brentwood, Tennessee, for processing and collection. From the point that the subrogation process is started, no related documents are included in the claim file, information on the "notepad" system discloses amounts recovered and deductibles, if any, returned. While there appears to be adequate documentation to justify claim decisions, there is inadequate documentation, in the claim file, for a proper review of the subrogation and salvage activities. **It is recommended that the Company have copies of subrogation and salvage documents returned to the main claim files so that a total picture of what happened throughout the settlement and recovery process is clear.**

A sample of twenty (20) closed claims with recoveries was reviewed. The files were found to contain adequate documentation of the Company's recovery efforts and return of deductible to insureds, where appropriate. Of these twenty (20) claims, nineteen (19) provided 100% reimbursement of the insured's deductible, whether the recovery was full or partial, and one (1) claim provided a pro-rata reimbursement of the deductible.

#### Unfair Claim Practices Review

The examiners reviewed the claim files from prior samples for violations of specific state unfair claim practices such as misrepresentation of policy provisions, concealment of coverage, and failure to promptly settle claims where liability has become reasonably clear. No material exceptions were noted.

The most common coverage issues resulting in claim denial were lapsed policy due to nonpayment of premium, unlicensed driver, and policy expired prior to loss date. The examiners reviewed the Company's documentation supporting decisions for a sample of twenty-six (26) files of denied claims and determined that the denials were appropriate and in accordance with policy provisions.

#### Claim Forms

The Company's claim forms were reviewed for content and appropriate and consistent usage. Form letters are produced on Company letterhead and most include a preprinted fraud warning statement at the bottom of the page. The Proof of Loss/Trust Agreement does not include any fraud warning statement. This is a violation of Tenn. Code Ann. § 56-53-111(b) (1) (A). **It is recommended that the company take the necessary action to comply with the requirements of Tenn. Code Ann. § 56-53-111(b) (1) (A) and include the appropriate fraud warning statement on all claims forms.**

## Loss Statistical Reporting

The purpose of this procedure is to review claim payments to determine if loss data is correctly coded as to the proper line of business and coverage. The Company uses several abbreviation/codes for loss expenses and payments. The files reviewed appeared to be correctly coded. Many differences were found in comparing the close date per the claims run and the close date in the file documentation. **It is recommended that the Company accurately report dates of claim file closure.**

## **SUMMARIZATION**

### Summary of Examiners' Recommendations and Comments:

#### Recommendations

#### **1. Company Operations/Management**

##### a) Intercompany Agreements: Account Settlement Agreement

The agreement by and between the Company and its affiliate, Direct Financial Services, Inc. a premium finance company, to settle the premiums financed, on a net basis, up to maximum of \$6 million without the specific approval of the Tennessee Insurance Commissioner. It was noted that the agreement is not signed. **It is recommended that the Company immediately take the necessary action to execute this agreement and forward a copy of the executed document to the Tennessee Department of Commerce and Insurance, Insurance Division, in accordance with the requirements of Tenn. Code Ann. § 56-11-206.**

##### b) Operations

The Company's affiliate, Direct General Insurance Agency, Inc. does marketing and provides underwriting services. As part of the services, the agency charges the applicant for the cost of securing the applicant's motor vehicle report (MVR). If a

policy is issued, the MVR cost is applied towards the premium. If the applicant declines the policy, the applicant receives the MVR. This charge is contrary to a directive issued, January 8, 1998, by the Tennessee Insurance Commissioner, to clarify the Department's position on the issue of fees charged by insurance agents. Based on the Department's bulletin, the agency is prohibited from charging the applicant for the MVR. **It is therefore recommended that the Company immediately direct the agency to cease charging insurance applicants for the MVR.**

## 2. Complaint Handling

Complaint Standard #1 requires that all complaints be recorded in the required format on the company complaint register. It appears the Company is not in compliance with this standard. **It is recommended that the Company ascertain that all written complaints including those received from insurance departments be logged into its Complaint Register, as recommended by NAIC Market Conduct Examiners Handbook.**

## 3. Producer Licensing

The examination disclosed that the Company is in violation of Tenn. Code Ann. §56-6-115 and §56-6-117 pertaining to appointments and terminations of producers. A number of producers' appointments and/or terminations were not reflected on the Tennessee Department of Commerce and Insurance, Agent Licensing Section's records. The Company was advised to contact the Tennessee Agent Licensing Section to resolve these exceptions. **It is recommended that the Company develop and establish procedures to ascertain that producer authorities are in accordance with Tenn. Code Ann. §56-6-101 et seq.**

#### 4. Claims

The Company's claim forms were reviewed for content and appropriate and consistent usage. The Proof of Loss/Trust Agreement does not include any fraud warning statement. This is a violation of Tenn. Code Ann. § 56-53-111(b) (1) (A). **It is recommended that the company take the necessary action to comply with the requirements of Tenn. Code Ann. § 56-53-111(b) (1) (A) and include the appropriate fraud warning statement on all claims forms.**

#### Comments

##### 1. Company Operations/Management

###### Subrogation

The Company utilizes the services of a law firm to assist in the collection of subrogation. As compensation for these services, the law firm deducts 33% of the recovered amount. There is no written agreement to outline this arrangement. Sound business practice dictates the need for an agreement outlining the arrangement. **It is recommended that the Company take the necessary steps and execute an agreement with the law firm of White, Schuerman, Rhodes & Burson and forward a copy of the executed agreement to the Tennessee Insurance Commissioner.**

##### 2. Underwriting

a) The review of a random sample of 100 policies disclosed an error rate of 48%. The errors consisted of the following: 22 files did not contain the application; 20 files contained an incorrect symbol; 5 files had invalid VIN numbers and 1 file did not contain updated endorsements.

The error of the 20 files with incorrect symbols appears to be in violation of Standard # 27, requiring that all policies be correctly coded. **It is recommended that the Company exercise greater care in the coding of policies and establish a procedure to verify data input into the system.**

b) Standard #18 test that the company verifies that the VIN number submitted with the application is valid and that the correct symbol is utilized. From the remaining seventy-eight (78) policies from the sample of one hundred (100), five (5) files, a 6% error rate, disclosed invalid VIN numbers. It appears the Company is not in compliance with this standard. **It is recommended that the Company establish a procedure to verify data input into the system.**

### 3. Claims

a) During the review of claim files, it was noted that from the point that the subrogation process started, no related documents were included in the claim file, information on the “notepad” system disclosed amounts recovered and deductibles, if any, returned. While there appeared to be adequate documentation to justify claim decisions, there was inadequate documentation, in the claim file, for a proper review of the subrogation and salvage activities. **It is recommended that the Company have copies of subrogation and salvage documents returned to the main claim files so that a total picture of what happened throughout the settlement and recovery process is clear.**

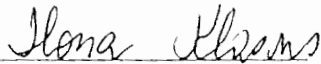
#### b) Loss Statistical Reporting

During the review of claim files, it was noted that the Company used several abbreviation/codes for loss expenses and payments. The files reviewed appeared to be correctly coded. Many differences were found in comparing the close date per the claims run and the close date in the file documentation. **It is recommended that the Company accurately report dates of claim file closure.**

## Conclusion

An examination has been conducted of the market conduct affairs of Direct Insurance Company for the period January 1, 2002, through December 31, 2003, with analyses of certain operations of the Company being conducted through June 18, 2004. The examination was performed in accordance with Tennessee insurance laws and regulations and market conduct procedures as promulgated by the NAIC

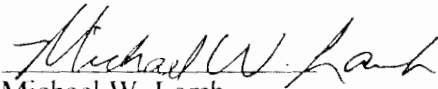
Respectfully Submitted,



Ilona Klasons, CIE, CFE  
Examiner-in-Charge  
State of Tennessee  
Southeastern Zone, NAIC



Bhavna Shah  
Examiner  
State of Tennessee  
Southeastern Zone, NAIC



Michael W. Lamb  
Examiner  
State of Tennessee  
Southeastern Zone, NAIC



Affidavit:

The undersigned deposes and says that she has duly executed the attached market conduct examination report of Direct Insurance Company, dated July 12, 2004, on behalf of the Tennessee Department of Commerce and Insurance. Deponent further says she is familiar with such instrument and the contents thereof, and that the facts therein set forth are true to the best of her knowledge, information and belief.

Ilona Klasons

Ilona Klasons, CIE, CFE  
Examiner-in-Charge  
Representing the Tennessee Department  
of Commerce and Insurance  
Southeastern Zone, NAIC

Subscribed and sworn to before me this

17<sup>th</sup> Day of August, 2004.

Notary: Helen M. Doring

County: Davidson

State: Tennessee

My commission expires: 3/25/06

# DIRECT INSURANCE COMPANY

J. Todd Hagely  
Vice President – Finance and Treasurer

Direct Dial: (615) 365-3605  
Email: todd.hagely@directins.com

September 22, 2004

## VIA HAND DELIVERY

Mr. Don Spann, CFE  
Insurance Examination Director  
State of Tennessee  
Department of Commerce and Insurance  
500 James Robertson Parkway  
Nashville, Tennessee 37243

Re: Market Conduct Examination of Direct Insurance Company  
Made as of January 1, 2002 through December 31, 2003

Dear Mr. Spann:

The purpose of this letter is to provide our responses to the Recommendations and Comments contained in the Market Conduct Examination Report (the "Report") of Direct Insurance Company (the "Company"). The Recommendations and Comments from the Report and our responses are as follows:

### Recommendations

#### 1. Company Operations/Management

##### a) Intercompany Agreements: Account Settlement Agreement

The agreement by and between the Company and its affiliate, Direct Financial Services, Inc. a premium finance company, to settle the premiums financed, on a net basis, up to maximum of \$6 million without the specific approval of the Tennessee Insurance Commissioner. It was noted that the agreement is not signed. **It is recommended that the Company immediately take the necessary action to execute this agreement and forward a copy of the executed document to the Tennessee Department of Commerce and Insurance, Insurance Division, in accordance with the requirements of Tenn. Code Ann. § 56-11-206.**

**Response.** The Account Settlement Agreement and the amendment to the Account Settlement Agreement were approved by the Department on December 1, 1994 and July 31, 1998, respectively, and were previously executed. (See Exhibit A) It is unclear why the examiner did not receive a signed copy. We would ask that this be removed from the Report.

b) Operations

The Company's affiliate, Direct General Insurance Agency, Inc. sales, does marketing and provides underwriting services. As part of the services, the agency charges the applicant for the cost of securing the applicant's motor vehicle report (MVR). If a policy is issued, the MVR cost is applied towards the premium. If the applicant declines the policy, the applicant receives the MVR. This charge is contrary to a directive issued, January 8, 1998, by the Tennessee Insurance Commissioner, to clarify the Department's position on the issue of fees charged by insurance agents. Based on the Department's bulletin, the agency is prohibited from charging the applicant for the MVR. **It is therefore recommended that the Company immediately direct the agency to cease charging insurance applicants for the MVR.**

**Response.** The Tennessee Department of Commerce and Insurance's January 8, 1998 bulletin addresses charges and costs incurred by an insured. (See Exhibit B) The bulletin appears only to apply to applicants that become insureds and not to applicants that are declined by us or that decide not to buy our policy. Our applicants sign an underwriting consent form acknowledging responsibility for reimbursing the agent for the cost of securing an MVR. In our situation, there are two scenarios:

1. An individual completes an application, an MVR is run and we and the individual agree that a policy will be issued. This individual becomes an insured and is not charged for the MVR; and
2. An individual completes an application, an MVR is run and a policy is not issued. This individual does not become an insured and is charged for the MVR.

Therefore, we believe we are acting in accordance with the Department's directive. We would ask that this be removed from the Report.

2. Complaint Handling

Complaint Standard #1 requires that all complaints be recorded in the required format on the company complaint register. It appears the Company is not in compliance with this standard. **It is recommended that the Company ascertain that all written complaints including those received from insurance departments be logged into its Complaint Register, as recommended by NAIC Market Conduct Examiners Handbook.**

**Response.** The Company is in the process of enhancing its procedures by incorporating a monthly reconciliation of the complaints in the Company's complaint log with the insurance departments' information in order to ensure accuracy. We are working with the insurance departments in all states in which the Company is licensed to fully implement this enhanced procedure.

### 3. Producer Licensing

The examination disclosed that the Company is in violation of Tenn. Code Ann. §56-6-115 and §56-6-117 pertaining to appointments and terminations of producers. A number of producers' appointments and/or terminations were not reflected on the Tennessee Department of Commerce and Insurance, Agent Licensing Section's records. The Company was advised to contact the Tennessee Agent Licensing Section to resolve these exceptions. **It is recommended that the Company develop and establish procedures to ascertain that producer authorities are in accordance with Tenn. Code Ann. §56-6-101 et seq.**

**Response.** The Company has enhanced its procedures by incorporating a monthly process whereby the Company's producer information is compared to insurance departments' information to ensure accuracy.

### 4. Claims

The Company's claim forms were reviewed for content and appropriate and consistent usage. The Proof of Loss/Trust Agreement does not include any fraud warning statement. This is a violation of Tenn. Code Ann. § 56-53-111(b) (1) (A). **It is recommended that the company take the necessary action to comply with the requirements of Tenn. Code Ann. § 56-53-111(b) (1) (A) and include the appropriate fraud warning statement on all claims forms.**

**Response.** A fraud warning statement has been included on the Proof of Loss/Trust Agreement. (See Exhibit C) The Company has incorporated the appropriate fraud warning statements in all claim forms required as a condition of payment of a claim.

## Comments

### 1. Company Operations/Management

#### Subrogation

The Company utilizes the services of a law firm to assist in the collection of subrogation. As compensation for these services, the law firm deducts 33% of the recovered amount. There is no written agreement to outline this arrangement. Sound business practice dictates the need for an agreement outlining the arrangement. **It is recommended that the Company take the necessary steps and execute an agreement with the law firm of White, Schuerman, Rhodes & Burson and forward a copy of the executed agreement to the Tennessee Insurance Commissioner.**

**Response.** An agreement between the Company and White, Schuerman, Rhodes & Burson has been executed. (See Exhibit D)

## 2. Underwriting

a) The review of a random sample of 100 policies disclosed an error rate of 48%. The errors consisted of the following: 22 files did not contain the application; 20 files contained an incorrect symbol; 5 files had invalid VIN numbers and 1 file did not contain updated endorsements.

The error of the 20 files with incorrect symbols appears to be in violation of Standard # 27, requiring that all policies be correctly coded. **It is recommended that the Company exercise greater care in the coding of policies and establish a procedure to verify data input into the system.**

**Response.** See response to 2.b) below. When a VIN number is corrected, no change to the symbol is made at that time. A project is pending which will change the symbol at the time of the renewal offer.

The policies files, including applications, of the 22 referenced files are attached. (See Exhibit E).

b) Standard #18 test that the company verifies that the VIN number submitted with the application is valid and that the correct symbol is utilized. From the remaining seventy-eight (78) policies from the sample of one hundred (100), five (5) files, a 6% error rate, disclosed invalid VIN numbers. It appears the Company is not in compliance with this standard. **It is recommended that the Company establish a procedure to verify data input into the system.**

**Response.** Over the past several years, Direct has made a concentrated effort to ensure that the policy files contain correct VIN numbers and thus have the correct symbol.

VIN numbers are checked for accuracy at entry point through the calculation of a Check Digit and also a verification that the VIN matches the correct year of the vehicle.

An agent has three tries to enter the correct VIN number. After that time, the system allows them to enter the number and the system reports it as an error on the following day. (On a multi-car policy, the automobile is not at the office so the agent cannot confirm the VIN and some Bill of Sales do not have a valid VIN number).

A correct VIN is matched against a VIN mask file (available from ISO) and a derivative of that file is used to obtain the valid Direct symbol.

To aid the agent, the agent can enter the year, make and model of the car and pick a description that best matches the car. This description will be associated with a VIN mask which will provide a symbol. If they have to manually enter a vehicle because there is no mask, then they use the price new chart to determine the symbol.

Incorrect VINs are reported back to the sales office on the day following the sale or a renewal to correct. After seven days, if the office has been unable to correct, the system generates a letter to the customer to ask for the proper VIN number. If it is still incorrect at renewal time, it is noted on the renewal offer that the customer must bring in the car or their registration when the policy is renewed.

When a VIN number is corrected, no change to the symbol is made at that time. A project is pending which will change the symbol at the time of the renewal offer.

### 3. Claims

a) During the review of claim files, it was noted that from the point that the subrogation process started, no related documents were included in the claim file, information on the "notepad" system disclosed amounts recovered and deductibles, if any, returned. While there appeared to be adequate documentation to justify claim decisions, there was inadequate documentation, in the claim file, for a proper review of the subrogation and salvage activities. **It is recommended that the Company have copies of subrogation and salvage documents returned to the main claim files so that a total picture of what happened throughout the settlement and recovery process is clear.**

**Response.** The Company can establish a process whereby copies of subrogation and salvage documents are available electronically through the Company's computer network.

#### b) Loss Statistical Reporting

During the review of claim files, it was noted that the Company used several abbreviation/codes for loss expenses and payments. The files reviewed appeared to be correctly coded. Many differences were found in comparing the close date per the claims run and the close date in the file documentation. **It is recommended that the Company accurately report dates of claim file closure.**

**Response.** There are several situations when the close date per the claims run could be different than the close date in the file documentation. These include expense payments and supplements coming in after the loss has been paid and the claim closed. These events after a loss has been paid do not extend the close date. Additionally, often certain features are closed (i.e. a collision claim) while others remain open (i.e. a physical damage claim).

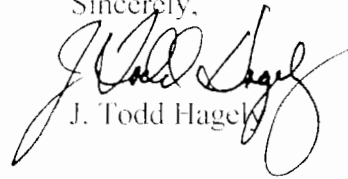
We are establishing a process to provide for a more complete close date as follows:

1. At the feature level, measure when the feature was opened not to "final payment", but to last payment on file, even if that last payment is a supplement. This is a better measure and will measure the true life cycle of the claim.

2. Measure the entire claim, not just the feature life cycle. This would be accomplished by measuring from the day the claim was reported to the last payment on the last open feature.

Attached is a marked version of the Report with our suggested changes. (See Exhibit F) We would like an opportunity to meet with you to discuss this further. In the meantime, if you have any questions or need any additional information, please let me know.

Sincerely,

A handwritten signature in black ink, appearing to read "J. Todd Hagek", with a stylized flourish extending from the end.

J. Todd Hagek

cc: Jacqueline C. Adair, President  
Direct Insurance Company